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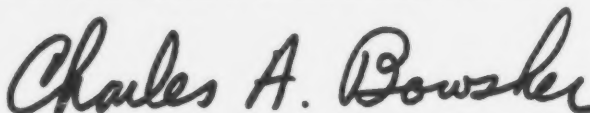
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The President of the Senate
The Speaker of the House of Representatives
The Commissioner-designate of Internal Revenue

In this report we summarize several tax administration issues that need closer attention. If these issues are not addressed, the Commissioner can expect (1) serious problems in processing tax returns, (2) a decline in taxpayer confidence in the tax system, and (3) a significant loss in tax revenues that could help reduce the deficit.

IRS needs to modernize its information technology, strengthen human resources, improve collection activities, and narrow the tax gap. As discussed fully in our October 1988 report on overall management at IRS and in other GAO reports and testimonies, IRS has agreed to take steps to resolve many of these issues. A new Commissioner of Internal Revenue will need to direct and encourage those efforts to improve the overall management of the Nation's tax system and collect additional revenues.



Charles A. Bowsher

Contents

Letter	1
Modernizing Information Technology	4
Strengthening Human Resources	7
Improving Collection Activities	10
Closing the Tax Gap	13
Related GAO Products	18
Transition Series	20

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Modernizing Information Technology

IRS' most pressing overall need is to modernize its outdated and inefficient tax processing system. Returns processing, storage, and retrieval processes are still very much paper-driven and labor-intensive. In March 1988, IRS approved a basic management plan and preliminary designs to improve its computer systems. The implementation of the plan is expected to take about 10 more years to complete and cost several billion dollars. Those estimates could change dramatically, however, because IRS had not, as of August 1988, identified alternative designs, made cost-benefit analyses, and selected a final design.

IRS cannot afford to wait until the mid-1990s for a solution to an impending computer capacity problem. If it does, the processing problems encountered in 1985 in processing tax returns and issuing refunds could reoccur.

- IRS and Congress need to impart the necessary sense of urgency to the redesign effort and ensure that the technical expertise and money are adequate to support the effort.

- A separate Deputy Commissioner with knowledge of, and responsibility for, managing information technology could provide needed direction for this massive endeavor.

IRS accounts for 90 percent of the federal government's revenue—\$886.3 billion in fiscal year 1987—and 60 percent of its delinquent receivables. But IRS' ability to satisfy its financial responsibilities has been seriously impeded by long-standing accounting systems problems. These problems are so severe that replacing some of these systems is the only feasible solution. Some systems are often unable to handle the volume of transactions. For example, 13 million payments were processed manually in 1986 because a system could not process all types of tax returns. Indeed, some of the systems are run on equipment that is no longer manufactured, making maintenance a constant problem.

Updating IRS' accounting and financial systems is a multimillion dollar effort. It has a better chance of succeeding if IRS

- designates and supports a chief financial officer position; and

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- develops a financial management plan to set priorities, fix accountability, and maintain and monitor financial system operations and improvements.

Strengthening Human Resources

Regardless of systems improvements, unless IRS does a better job of managing its people, it will still not be as effective or efficient as it could be. IRS needs to establish an agencywide human resources plan. It will then be in a better position to provide more central direction and oversight to human resources management throughout the Service.

As IRS automates further, this plan will need to take into account the implications for human resources of an increasingly sophisticated technological environment in which IRS employees will operate. IRS' ability to effectively satisfy its mission will depend to a large extent on its employees' abilities to work effectively in an increasingly automated environment.

Previously, human resource issues were often considered only after an automation project's planning had been completed. That was a mistake. Human resource issues need to be analyzed before a project's conceptual design is approved. That analysis needs to consider the potential effect on the number of employees, the skills, and the training needed to successfully integrate the system into the work place. Then IRS can recruit staff and develop them accordingly.

Presently, many of IRS' recruiting problems stem from its inability to compete with salaries offered by the private sector. In some geographic areas, returns processing staff in the service centers are paid less than employees of local fast food restaurants. IRS faces the same dilemma in trying to recruit revenue agents. It cannot match the salaries offered top accounting graduates by certified public accounting firms and other private employers. Even so, IRS could improve its competitive position through more modern and sophisticated recruiting.

Once staff are hired, quality training is critical to IRS' ability to effectively administer the tax laws. IRS needs to improve its training program.

- A 1987 GAO survey of IRS employees showed that about 57 percent believed their training on tax law changes was less than adequate.
- Our recent work has identified the need to improve the training of employees responsible for answering taxpayer correspondence and telephone inquiries. IRS employees gave incorrect answers 36 percent of the time during the 1988 filing season to people who called for advice.

- We also found that about 50 percent of a sample of letters sent to taxpayers were either incorrect, incomplete, unresponsive, or unclear.

IRS has attempted to improve service quality by emphasizing quality as a priority, implementing a quality assurance plan, hiring seasonal staff earlier in order to provide them more training, and monitoring responses to taxpayers more closely. These efforts are worthwhile and should be continued. IRS should also identify and pay particular attention to recurring service problems to develop ways to resolve them.

Improving Collection Activities

Another area much in need of attention is collecting taxes owed the government.

- As of December 31, 1987, IRS reported a total accounts receivable balance of about \$56 billion.
- Although IRS' Internal Audit Division estimates that about \$33 billion of the balance is collectible, IRS has little detailed information on the collectibility of the accounts and does not know what collection tools are most effective.
- IRS historically has not paid enough attention to the problem. The result—IRS has been unable to reduce the growth of accounts receivable and collect delinquent taxes, thus depriving the government of a significant source of revenue for reducing the budget deficit. This situation must change.

IRS' accounts receivable figures include duplicate and erroneous delinquencies and amounts that are uncollectible. For example, about \$5 billion of the \$56 billion inventory are duplicate assessments of employment tax delinquencies. On the other hand, accrued penalties and interest are not included. The amounts of erroneous delinquencies and uncollectible accounts are unknown. IRS has some

major initiatives underway to develop more accurate accounts receivable figures. While some improvements are expected in the near future, it may be years before IRS' management information system produces reliable information. An accelerated effort is needed to reliably estimate how much can be collected in the short term.

All too often the immediate response to dealing with the collection problem has been to seek more resources. But, IRS does not know how effective its existing tools are and whether problems exist that need to be addressed. Thus, providing additional resources to collect outstanding delinquencies may not be the best solution. IRS should determine whether existing collection tools, such as periodic notices, levies, and seizures, can deal more effectively with the collection problem.

The most efficient way of dealing with delinquencies is to prevent them from occurring. Unfortunately, IRS' efforts have not been commensurate with the potential benefits. Little has been done to determine why tax delinquencies occur. Without this information, prevention programs will be difficult to develop and neither Congress nor IRS will be in a good position to assist in preventing delinquencies.

The next most efficient way to deal with delinquencies is their early detection. Early detection programs can also bring about improved collection results through reduced delinquencies, particularly for those taxes, such as employment taxes, where additional delinquencies could pyramid quickly before strong collection action is taken. Employers' nonpayment of employment taxes poses significant problems for Congress and IRS. By the time IRS begins collection, the business has, in many situations, such a large delinquency that payment is unlikely. Thus, IRS is faced with seizing the business' assets to collect the outstanding debt and halt future delinquencies. This action can raise socioeconomic issues by causing the business to file for bankruptcy, adding to unemployment.

Closing the Tax Gap

Collecting taxes and penalties already assessed is one problem. An even more intractable one is identifying the correct amount of taxes owed in the first place.

- IRS estimates taxpayers will not pay \$87.1 billion in income taxes owed the government for 1988—\$64.3 billion in unpaid individual income taxes and \$22.8 billion unpaid by corporations.
- This amount could grow to almost \$114 billion by 1992.
- There are specific pockets of unpaid taxes that IRS can seek to collect more vigorously.

It is essential that IRS audit more returns each year to improve compliance. The number and percentage of tax returns examined have declined steadily since the late 1970s. IRS examined 42 percent fewer returns in 1987 than in 1978—a decline from 2.3 percent to 1.1 percent of filed returns.

Congress agreed. In fiscal years 1987 and 1988, Congress provided IRS the money to hire 2,500 more examination personnel each year. This was two-thirds of a revenue initiative intended to increase examination coverage from about 1 to almost 2

percent of all returns filed and raise about \$10 billion more in revenues between 1987 and 1991. Even so, IRS audited fewer returns in 1987 than the year before because of problems with recruiting revenue agents.

But IRS generated more revenue by concentrating on cases with a higher potential for tax adjustments. While generating more revenues is clearly desirable, especially in an era of budget deficits, it is at the cost of achieving higher levels of coverage across all taxpayer classes. The question is whether more widespread coverage would generate more revenue over the long term by encouraging greater taxpayer compliance. Although reconciling these two competing concerns is difficult, it is necessary.

Other actions can also increase revenues. Each year businesses (sole proprietorships, partnerships, and corporations) earn billions of dollars in third-party income, such as interest and dividends. Corporations reported about \$495 billion in interest alone on their 1983 tax returns, while individuals reported \$154 billion in interest income for that year. IRS receives millions of business information returns each year for this type of income but does not match them to business tax returns. In

contrast, IRS has a well-established information returns matching program for individuals that it uses to identify unreported income that may be subject to tax. In 1987, IRS notified 5 million individuals of potential unreported income problems, which generated \$2.8 billion in net additional taxes and penalties. IRS considers this program to be cost effective, with a yield-to-cost ratio of 16 to 1 in 1987.

The idea for a document matching program for businesses has been around since at least 1981. However, IRS has not developed one, even though it estimates that business income, partly subject to information returns reporting, accounts for a large part of the tax gap.

- IRS should develop a business information returns program. With its existing systems, IRS could use information returns to identify business nonfilers and sole proprietors who underreport income.
- IRS should also design an information returns program to cover partnerships and corporations.
- IRS is currently studying the merits of a business information returns program but does not expect to complete the study until

fiscal year 1991. IRS should not wait until 1991 to act.

IRS has major problems identifying and taxing unreported income where no clear paper trail exists, such as informal supplier or "off-the-books" income, and income from illegal sources and unrelated business activities of tax-exempt organizations. IRS officials recognize that they are making few inroads into reducing the informal supplier tax gap, estimated to be \$7.7 billion for 1987. We reported that special enforcement program investigations closed in 1982 produced only about \$2 million in taxes on illegal income—a tax gap area estimated to be in the billions of dollars. In May 1988 testimony IRS officials also said that fewer than 10 percent of tax-exempt organizations file required tax returns on unrelated business income.

It may be difficult to get at these types of unreported income, but IRS must continue to strive for innovative ways to do so. In our 1986 report on tip income, we discussed one district's innovative computer scoring system designed to identify businesses' unreported tip income and recommended that IRS use this system nationwide. As in the tip income initiative,

IRS should encourage its employees to formulate new techniques to detect unreported income in other areas where noncompliance is a significant problem.

The current IRS tax gap does not include estimates for other compliance problems, such as unpaid excise taxes or employment taxes. IRS has not estimated the size of these problems because it does not have the data and methods to do so. Consequently, it is difficult to determine how much additional revenue might be generated by applying additional resources to these areas.

Indications are that significant compliance problems exist in these areas. For example, we reported in 1987 that a large number of independent importers had not paid an estimated \$6 million in gas guzzler excise taxes. In addition, IRS believes it has a potentially significant problem involving employers who misclassify workers as independent contractors to avoid employment taxes. IRS should strive to estimate the magnitude of these and other compliance problems. With such estimates, IRS would be in a better position to know how much additional revenue could be collected and begin to design cost-effective strategies for collecting it.

Related GAO Products

Managing IRS: Actions Needed to Assure Quality Service in the Future (GAO/GGD-88-1, Oct. 14, 1988)

Computer Capacity: IRS Must Better Estimate its Computer Resource Needs (GAO/IMTEC-87-5BR, Nov. 4, 1986)

Computer Support for Tax Processing Needs Continuing IRS Attention (GAO/T-IMTEC-87-1, Feb. 6, 1987; GAO/T-IMTEC-88-1, Feb. 23, 1988)

ADP Modernization: IRS' Redesign of Its Tax Administration System (GAO/IMTEC-88-5FS, Nov. 9, 1987)

ADP Modernization: IRS' Tax System Redesign Progress and Plans for the Future (GAO/IMTEC-88-23BR, Apr. 27, 1988)

Tax Administration: IRS' Implementation of the 1987 Revenue Initiative (GAO/GGD-88-16, Dec. 2, 1987)

Tax Administration: Difficulties in Accurately Estimating Tax Examination Yield (GAO/GGD-88-119, Aug. 8, 1988)

IRS' Correspondence With Taxpayers and Its Telephone Assistance Program (GAO/T-GGD-88-47; GAO/GGD-88-101, July 13, 1988)

The 1988 Tax Return Filing Season and IRS' Fiscal Year 1989 Budget (GAO/T-GGD-88-30, Apr. 13, 1988)

Tax Administration: IRS' Tax Gap Studies (GAO/GGD-88-66BR; GAO/T-GGD-88-22, Mar. 31, 1988)

The Merits of Establishing a Business Information Returns Program (GAO/T-GGD-87-4, Mar. 17, 1987)

Tax Administration: IRS' Efforts to Establish a Business Information Returns Program (GAO/GGD-88-102, July 22, 1988)

Tax Administration: Investigating Illegal Income—Success Uncertain, Improvements Needed (GAO/GGD-88-61, Apr. 25, 1988)

Tax Administration: Tip Income Reporting Can Be Increased (GAO/GGD-86-119, Sept. 30, 1986)

Tax Administration: Gas Guzzler Tax Compliance Can Be Increased (GAO/GGD-87-85, July 16, 1987)

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